CalPERS

Actuarial & Employer Services Branch
P.O. Box 942709
Sacramento, CA 94229-2709
Telecommunications Device for the Deaf - (916) 795-3240
(**888**) CalPERS (225-7377) FAX (916) 795-3005

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AGENDA ITEM 08

TO: MEMBERS OF THE BENEFITS AND PROGRAM ADMINISTRATION COMMITTEE

I. SUBJECT: Update on the Furlough Impact on Benefits and Member/Employer Contributions

II. PROGRAM: Actuarial & Employer Services

III. RECOMMENDATION: Information Only

IV. ANALYSIS:

At the February 18, 2009, Benefits and Program Administration Committee (BPAC) meeting, Chief Actuary Ron Seeling provided information regarding furlough impacts as part of the Chief Actuary Report. At that meeting, a request was made to bring forward an agenda item which documents the impacts of furloughs on member benefits and member/employer contributions as well as provides any updates.

Since the February meeting, we have received verification that the State intends to base its employer contribution on earnings as reduced by the effect of the furlough, even though members will largely earn full benefits. In response to the State's decision, CalPERS staff sent a letter to the Department of Personnel Administration (DPA) and Department of Finance that notified the State that its failure to pay contributions based on unreduced salary will result in an unfunded liability and outlined the Board's authority and responsibility respecting administration of the System. A copy of the letter is found in Attachment A.

Although it is within the Board's power to adjust an employer's contribution rate in order to avoid the creation of an unfunded liability, until completion of the June 30, 2009 actuarial valuation, the amount of any unfunded liability created by the furloughs will not be known. If at the time the valuation is completed there are any resulting unfunded liabilities, those liabilities will be addressed during the annual employer valuation process, and ultimately rolled into future employer rates.

The tentative contract agreement for some State bargaining units has not yet been ratified by the membership and approved by the legislature. DPA has drafted proposed legislation to authorize service credit based on the amount of service that would have been credited had members not been in the State's furlough program. This unreduced service credit will apply to individuals covered by a collective bargaining agreement that contains provisions defining a furlough program, or to individuals subject to an Executive Order requiring mandatory furlough for State employees. Without further statutory changes, service credit reductions will remain an issue for school and public agency members.

DPA has confirmed that no State member has special compensation paid as a percentage of earnings (see Member Benefits section, below, for an explanation of how special compensation can affect final compensation). Therefore, no State member will have reduced final compensation as a result of the furloughs. However, some public agency and school members do have such earnings-based special compensation, and as such, their final compensation may be affected should furloughs be implemented.

Below is an explanation of specific effects a furlough may have on member benefits and on member and employer contributions.

Member Benefits

A member's retirement allowance is computed based on benefit formula, final compensation and service credit. The benefit formula is unaffected by a furlough. However, there may be an impact on final compensation and service credit.

Final Compensation

Final compensation is the highest average annual compensation earnable over a 12 or 36 month period depending on member classification and bargaining unit, as set forth in the law. Compensation earnable is comprised of payrate and special compensation. Special compensation is a payment received for special skills, knowledge, abilities, work assignment, workdays or hours or other work conditions. A furlough does not change payrate, nor would it change special compensation in most instances when items of special compensation are paid as a flat dollar amount or a percentage of payrate. However, a furlough could reduce special compensation amounts that are paid as a factor of earnings (e.g., Reporting the Value of Employer Paid Member Contributions). Therefore, in some cases final compensation could be reduced, but only for members with earnings-based special compensation whose highest 12 or 36 month period at retirement includes furlough time.

Service Credit
One year of service credit is granted for full time employment for any of the following: 10 months of service for persons employed on a monthly basis; 215 days of service for persons employed on a daily basis; or 1,720 hours of service for persons employed on an hourly basis. Part time members accrue a ratio of service credit rendered toward the criteria outlined.

Under a furlough plan, all members will accrue service at a slower rate during the fiscal year. However, since one year of service credit can be accrued in less than a year, full time members employed continuously throughout the fiscal year may be able to accrue a full year of service credit. For example, a full time member working continuously during a two day per month furlough plan would still earn a full year of service credit.

Part time members would generally have a reduction to the overall amount of service credit accrued. The overall reduction will depend upon the percent of full time normally worked and the number of furlough hours.

Members with appointments of less than 12 months may see an impact. In addition, members who take a leave of absence, or are hired or separate from service during a furlough plan, may see a reduction to the overall amount of service credit accrued because of their slower accrual rate. Their service will be based on the ratio of service accrued up to the separation or leave date to the full time amount required.

Member/Employer Contributions

The Public Employees' Retirement Law provides that member contribution rates are to be applied to actual earnings, not compensation earnable. Therefore, when the member contribution rate is multiplied by the furlough-reduced member earnings, it will result in reduced member contributions payable to CalPERS.

The employer contribution rates set by the CalPERS Board are a percentage of payroll, and thus tied to actual earnings. Therefore, a furlough that reduces payroll would necessarily result in reduced employer contributions to CalPERS.

The following illustrates the effect furloughs would have on employer contributions in the context of the State, as an employer. The agenda item in May 2008, which set the State employer rates, contained the estimated dollar contribution for Fiscal Year 2008-09 of $3.025 billion. The first two quarters of the State contributions were received in a timely manner and amount to $1.580 billion. We have estimated the State contributions for the 3^{rd} and 4^{th} quarters to be approximately another $1.580 billion, ignoring the impact of any furlough.

This would mean an actual contribution for Fiscal Year 2008-09 of about $3.160 billion without a furlough (or about $135 million more than the estimate in the Board's May 2008 agenda item). With the State furlough (either the original two day per month furlough or the reported one day per month furlough in the tentatively bargained version), we estimate that CalPERS will receive between $3.030 and $3.083 billion from the State for Fiscal Year 2008-09. Most important, this amount is still more than the amount of contributions that were estimated at the time the Board set the rate in May 2008.

Since furlough plans for schools and public agencies will be designed and implemented differently depending on each employer's unique situation, it is not possible to perform this type of basic analysis for all of CalPERS' employers.

To the extent contributions received are less than would have been received had there not been furloughs, CalPERS may well be collecting less in both employer and member contributions than it would otherwise have received. However, this is not necessarily a problem. There will be other factors that impact the liabilities that the basic analysis explained above does not consider. In the current economic environment, wage inflation may be less than assumed. This could cause gains that would not otherwise have been anticipated. Similarly, it is very likely that CalPERS will experience significant asset losses during the current fiscal year. The CalPERS funding policies have mechanisms to deal with all gains and losses, whether from member contributions, employer contributions, salary experience, investment experience or otherwise. CalPERS makes adjustments to future employer contribution rates as appropriate.

Whether the employer's intention is to reduce member benefits or not, members have a vested contractual right to an actuarially sound system, and the California Constitution vests the CalPERS Board of Administration with plenary authority and fiduciary responsibility to administer the System in a manner that will assure prompt delivery of benefits to participants and their beneficiaries. In addition, the Board has the sole and exclusive power to provide for actuarial services in order to assure the competency of the assets of the retirement system, and is authorized by the Public Employees Retirement Law to adjust the amount of the employer contributions in order to maintain the actuarial soundness of the System.

It is within the Board's power to determine, at any time, that an employer's contribution must be adjusted in order to avoid the creation of an unfunded liability that may result during a period when employer contributions are affected by furloughs. In exercising that power, the Board, in consultation with its actuarial experts, should consider whether the changes, if any, in an employer's contributions due to furloughs will potentially threaten the actuarial soundness of the System.

Reduced member and employer contributions due to furloughs, coupled with earning of full benefits (if that is the intention under any proposed furlough) could potentially create an unfunded liability. For the State and schools, this may not be known until the June 30, 2009 valuation which is expected to be completed in May, 2010. For public agencies, it may not be known until October, 2010. For the reasons stated above, we recommend the Board take no action at this time to collect additional member and employer contributions due to furloughs, but reserve the right to change rates in the future.

Finally, we note that under standard actuarial processes at CalPERS, unfunded liabilities are amortized over 30 years in the employer rates and accrue interest at 7.75% per annum. Under Board policy, employers have the right to submit additional payments to CalPERS and may therefore choose to make contributions to CalPERS based on unreduced earnings.

V. STRATEGIC PLAN:

This item is not a specific product of the Strategic or Annual Plans but is part of the regular and ongoing workload of the Actuarial & Employer Services Branch.

VI. RESULTS/COSTS:

There are no costs associated with this item.

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Ronald L. Seeling, Chief Actuary
Actuarial and Employer Services